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TAGS: [EAGR](#) [ECON](#) [ETRD](#) [KCOR](#) [KDEM](#) [KPRV](#) [PGOV](#) [IZ](#)
SUBJECT: CAUTIOUS BEGINNINGS TO FOOD SUBSIDY REFORM

REF: A. BAGHDAD 375
 [B](#). BAGHDAD 241

[C](#). 2005 BAGHDAD 5079
 [D](#). 2005 BAGHDAD 4559
 [E](#). 2005 BAGHDAD 4108

Classified By: Deputy Chief of Mission David Satterfield, reasons 1.4 (b) and (d)

[11.](#) (C) Summary: Evidence on the ground indicates that the GOI intends to reform -- and eventually eliminate -- its Public Distribution System (PDS), a \$3 billion subsidy program that fails in its mission of ensuring food security for all Iraqis. The Embassy PDS Reform Team (chaired by Embassy Econ) supports this decision as economically necessary and will provide advice and assistance to the GOI as appropriate. The PDS, managed by the Ministry of Trade (MoT), is reportedly foul with corruption and drains government revenues that could be used for essential public services. It hinders agricultural and private-sector economic development by setting up the MoT as the dominant buyer of high-grade wheat and rice in Iraq and as a no-cost provider of other food and living items. The GOI has said that it intends to cut "nonessential" items from the PDS and monetize it, establishing government reserves of key PDS items to guard against price inflation and market shortages and to act as a contingency stock in case of food emergencies. The GOI recently carried out a monetization experiment and touted its success as proof that it can monetize the PDS effectively. The GOI has also implemented policies -- albeit to a limited extent -- to encourage private-sector development in food production, processing, distribution, and marketing. The GOI has stated its intention to phase out the PDS over the next four years, freeing up a significant portion of its budget, and its 2006 PDS budget cut is evidence of GOI seriousness. Throughout the PDS reform process, we will encourage the GOI to educate the Iraqi public on the necessity and benefits of PDS reform and link it to the recently launched Social Safety Net, which is intended to protect the poorest Iraqis. End summary.

A Socialist Hindrance to Development

[12.](#) (C) The Public Distribution System (PDS) is a massive subsidy program in which all Iraqis are entitled to receive a monthly basket of foodstuffs and household items. The 2006 PDS budget is \$3 billion, or 9% of Iraq's total government budget. Another U.S. agency has estimated that the Iraqi Ministry of Trade (MoT), which manages the PDS, spends approximately \$30 per monthly PDS basket, while the actual market value per basket is around \$9. Embassy market surveys confirm this. According to Kareem Abdul Fajer (please protect throughout), Director General (DG) of Foodstuffs (the MoT state-owned enterprise responsible for procuring most items in the PDS basket), transportation costs are \$0.54 per

monthly basket. This leaves approximately \$20 per monthly basket that is lost to inefficiencies and corruption.

¶3. (C) The 2006 PDS budget of \$3 billion is a 25% cut from 2005. In 2005 the MoT managed to spend only about \$2 billion, or 50% of the budget, on actual procurement. According to the British Department for International Development (DFID) and the Iraqi Ministry of Finance (MoF), the main hindrance to spending the entire 2005 budget was contracting mismanagement within the MoT. (Note: The MoT has stated that the problem was unavailability of funds from the MoF. End note.) According to USAID/Food for Peace, in the past the MoT has announced "executed contracts" that led many of us to believe the food procurement was a completed transaction. However, we later learned that delays in the issuance of Letters of Credit, irregular financing arrangements with foreign banks, and amendment requests by suppliers often led to delays or cancellations of the "executed contracts."

¶4. (C) Bi-weekly World Food Program (WFP) reports indicate an average PDS delivery shortfall of nearly 77% over the last six months of 2005. (Note: Using the \$30 basket cost, the amount of food procured by the MoT after spending \$2 billion roughly correlates to the 77% shortfall observed by the WFP. End note.) U.S. military field reports confirm that most Iraqis do not receive their entire allotted ration basket each month. This is particularly damaging in the poorest areas of Iraq -- located mainly in the far western regions of Anbar and Ninewa provinces and pockets of southeast Iraq -- where, according to the 2003 UN WFP Baseline Food Security Analysis (the most recent available), about a third of the population is highly dependent on the PDS for survival.

¶5. (C) The PDS is reportedly corrupt at every stage of its

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operation, from procurement contracting to final distribution of items to the Iraqi public. Deputy Prime Minister

al-Jabbari (strictly protect) has told us that Trade Minister Mawlud skims money from sugar contracts. DG Kareem and MoT Chief of Staff Azad Hussein Rasheed have stated that PDS-laden trucks regularly disappear enroute to food distribution points, and that MoT officials sometimes sell PDS food articles to enrich themselves. A previous Iraq Reconstruction Management Office (IRMO) Trade Senior Consultant strongly suspected that foreign wheat shipments were being resold to fund terrorist operations and indicated that the MoT Inspector General office was likely involved in corrupt activities. Recent Iraqi press reports credit the MoT with being the most corrupt ministry in the GOI. Local Embassy hires confirm the widespread impression that government officials at all levels of the MoT enrich themselves through the PDS.

¶6. (C) The PDS hinders agricultural and private-sector development by sapping entrepreneurial initiative and encouraging dependence on the government. Deputy Prime Minister Chalabi has told us that he instructed the MoT to offer higher prices to Iraqi producers for wheat and rice (ref B). (Note: We do not have evidence beyond verbal assurances from MoT officials that they actually pay higher prices to Iraqi producers. End note.) However, using Ministry of Agriculture production estimates and MoT procurement records, we estimate that less than half of Iraqi wheat production is considered fit for PDS procurement, and the farmers are currently only capable of producing about 12% of annual PDS wheat needs. In addition, as ration recipients and corrupt MoT officials reportedly sell PDS items into the marketplace, they deflate and distort true market prices, making it difficult for Iraqi farmers to recover production costs on wheat and rice that they do not sell to the MoT. In effect, the MoT has set itself up as the dominant buyer of high-grade wheat and rice in Iraq, providing no incentive to private-sector buyers to enter the market and decreasing the

need for GOI investment in distribution infrastructure that would benefit small farmers and private distributors.

Cutting "Nonessential" Items

¶ 17. (C) According to DG Kareem, the most important items of the PDS are flour, rice, sugar, and cooking oil, mainly because Iraqis most need these items for daily living and because Iraqi farmers are currently incapable of producing sufficient quantities. "Nonessential" PDS items, according to Kareem, make up 25% of PDS expenditures and include adult milk, infant milk, baby food, beans, salt, tea, soap, and detergent. According to Kareem and local sources, Iraqis generally view these "nonessential" items as inferior in quality and prefer to buy higher-quality replacements in local retail markets. These same sources indicate that the Iraqi recipients often sell the "nonessential" items for income, though the income they receive is significantly lower than what the GOI paid to provide the item initially. Kareem has told us that the MoT plans to discontinue providing "nonessential" PDS items in 2006. (Note: Though press reports state that the MoT has done this, MoT sources indicate it has not happened.)

Providing Freedom of Choice

¶ 18. (C) Deputy Prime Minister (DPM) Chalabi recently told us that the GOI plans to monetize the PDS, giving Iraqis the opportunity to procure what they believe they need and spurring private-sector development in areas that the market (and not the government) dictates. Minister of Planning Barhim Salih has echoed this position to Embassy officials, and MoT Chief of Staff Azad has told us the MoT is conducting studies in Dahuk and Muthana provinces to determine whether or not Iraqis would embrace monetization. In any case, we believe that PDS monetization would be a long and difficult process.

¶ 19. (SBU) According to recent Baghdad market prices, the annual cost to the GOI to provide every Iraqi with the monetary equivalent of a PDS basket would be approximately \$2.7 billion. Embassy supports the monetization decision and believes that the GOI should monetize gradually, starting in a province where private food distribution and marketing channels are already fairly strong, and then expanding to other provinces over time. As the monetization program spreads, the GOI will likely need to continue providing flour, rice, sugar, and cooking oil to the provinces where monetization has not yet been implemented.

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¶ 10. (C) The GOI recently completed a "catch-up" voucher program, through which they compensated all Iraqi households for food shortages from January through August 2005. The GOI distributed approximately \$450 million through over four million vouchers, which Iraqis cashed at the nearest branch of the Rafidan or Rashid state-owned bank. According to Embassy, DFID, and GOI officials, the program was successful, despite glitches in a few cities. DPM Chalabi said the program demonstrated the GOI's ability to monetize the PDS successfully.

¶ 11. (C) According to USAID's Agriculture Reconstruction and Development Program in Iraq (ARDI), most of Iraq's retail markets would likely be capable of providing sufficient quantities of most PDS items in the absence of a government-operated PDS. The main exception would possibly be flour. Embassy Econ has collected market surveys that monitor price and availability of PDS items across Iraq, and, though the December fuel-price increases have caused food

prices to go up in some areas, most PDS items have been readily available during "spot" surveys. It is uncertain how much of the local markets' food comes from PDS items sold into the market by undesiring recipients or corrupt MoT officials.

¶112. (C) As the GOI gradually discontinues procuring immense amounts of food, initially there may be supply shortages and price spikes in certain areas as private markets become fully functional. DPM Chalabi has said that the GOI plans to maintain reserves of flour and rice to sell on the open market at predetermined price marks (above market prices) to help hedge against food-price inflation. Embassy supports this action and believes that the GOI should also maintain reserves of cooking oil and sugar because there is no domestic production of these key PDS items. The GOI could also distribute the reserves to impoverished areas if food shortages occur.

Encouraging Private-Sector Growth

¶113. (C) DPM Chalabi told us that he has instructed the MoT to procure domestically as much of its flour and rice reserves as possible, exhausting all Iraqi procurement options before turning to foreign suppliers. MoT Chief of Staff Azad confirms that the MoT follows this policy. Iraq's population is projected to grow to 43 million by 2030, and it will need to import food supplies for the foreseeable future; however, this policy of maximizing domestic procurement will encourage Iraqi farmers to produce more wheat and rice, traditionally strong agricultural products for Iraq. It will also indirectly encourage private-sector development in Iraq's food distribution and marketing channels.

¶114. (U) Embassy PDS Reform Team will encourage the GOI to institute additional policies and programs to encourage private-sector development in Iraq's food distribution and marketing channels. One way would be for the GOI to sell its imported wheat to Iraq's 120 privately-owned flour mills, and for millers to in turn make a market in the flour they produce through developing private-sector distribution channels. Currently, the MoT provides wheat and pays the mills to produce flour, which the MoT then distributes through the PDS. Another way for the GOI to encourage private-sector growth would be to target loan programs to entrepreneurs who want to establish small- to medium-sized food-processing or distribution companies. The GOI could also use the savings from the declining PDS budget to improve infrastructure and support programs that would contribute to improved private-sector activity.

Eliminating the PDS

¶115. (C) The GOI has said it intends to eliminate the PDS over a four-year period, gradually drawing down the budget as food production, processing, and distribution strengthen and freeing up resources for increased public investment. Several GOI officials, including Finance Minister Allawi, have said the PDS budget should be cut by 25 percent per year for four years and then eliminated. The 25 percent budget reduction from 2005 to 2006 supports the seriousness of these official statements. (Note: The PDS budget was also cut by 20 percent from 2004 to 2005. End note.)

¶116. (U) PDS expenditure is not mandated as an economic reform by the International Monetary Fund (IMF). This is a reform that exceeds what the IMF has asked for (reform through "enhanced financial monitoring and improved procurement procedures") and demonstrates a progressive

Educating the Iraqi Public

¶17. (U) As the GOI reforms and eventually eliminates the multi-billion dollar PDS subsidy, Embassy will encourage the GOI to link the recently implemented Social Safety Net to PDS reform in the public mind. This new Safety Net is intended to protect the poorest Iraqis as economic reforms are implemented, and, according to Iraqi public affairs officials, Iraqis will not be supportive of subsidy reductions unless they believe the Safety Net works. We will also encourage the GOI to educate average Iraqis on how corruption and inefficiency have plagued the PDS system, outweighing any benefits.

¶18. (SBU) Embassy Econ and the MoF co-chair the Economic Reform Public Education Working Group, which also includes Embassy Public Affairs, Treasury, USAID, DFID, the Iraqi Government Communications Directorate (GCD), and representatives from most Iraqi ministries. PDS reform public-education messages could be coordinated effectively through this working group, which is currently developing and delivering public messages to support fuel-subsidy reductions and anti-corruption efforts.

Comment: Stopping the Cultural Damage

¶19. (C) Two of the main impediments to Iraq's development of a healthy market-driven economy are massive government subsidies and endemic government corruption. The PDS contributes significantly to both of these. Most critically, however, there is no objective measure for how damaging the current PDS is (and has been) to Iraq's development into a free and democratic society. As long as the GOI continues to pour billions of dollars into the PDS, average Iraqis will be faced with a corrupt government bureaucracy that saps personal initiative without supplying any real benefit to the population. As MoT Chief of Staff Azad has told us: "We do not want to teach the Iraqi people to be lazy." To achieve the transparency and citizen self-reliance necessary for successful democratic government, the GOI should eliminate the PDS and continue to strengthen the new Social Safety Net that supports Iraq's truly needy.

¶20. (U) We will do everything in our power to encourage the new Iraqi government to continue the PDS reform policies of its predecessor, following the established principles of cutting "nonessential" items, providing freedom of choice through monetization, encouraging private-sector growth, gradually eliminating the PDS, and educating the Iraqi citizenry.

KHALILZAD